

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 17th Floor
Sacramento, CA 95814

PROPOSED DECISION

FILE NUMBER REG-2007-00015

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to pure premium rates for workers' compensation insurance, California Workers' Compensation Uniform Statistical Reporting Plan—1995, and the California Workers' Compensation Experience Rating Plan—1995. These regulations will be effective on **July 1, 2007**.

EXPLANATION AND HISTORY

A public hearing in the above captioned matter was held on May 3, 2007 at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG 2007-00015 dated March 30, 2007, which is included in the record. At the conclusion of that hearing, and as noticed in the Notice of Proposed Action and Notice of Public Hearing, the hearing officer announced that the record would be kept open for additional written comment until 5:00 p.m. on Thursday, May 10, 2007. The record was closed at 5:00 p.m. on May 10, 2007.

The record discloses the persons and entities to whom or which the Notices were disseminated. The Notice summarized the proposed changes and recited that a summary of the information submitted by the Insurance Commissioner in connection with the proposed changes was available to the public. In addition, the "Filing Letter" dated March 30, 2007 submitted by the Workers' Compensation Insurance Rating Bureau of California (WCIRB) and related documents were available for inspection by the public at the Sacramento office of the Department of Insurance and were available online at the WCIRB website, www.wcirbonline.org.

The WCIRB's filings proposed Pure Premium Rates that reflect insurer loss costs and loss adjustment expenses and adjustments to the California Workers' Compensation Experience Rating Plan—1995 to conform to the proposed Pure Premium Rates. In addition, the WCIRB has proposed amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995 and California Workers' Compensation Experience Rating Plan—1995.

Testimony, written and oral, was taken at a hearing in San Francisco on May 3, 2007 and exhibits were received into the record. Additional documentation requested by the hearing panel was submitted subsequent to the hearing but prior to the close of the time period to receive written comment. The matter was submitted for decision at the conclusion of the period to receive written comment. The matter having been duly heard and considered, the following Proposed Decision and Proposed Order are hereby made.

THE PURE PREMIUM RATES

Pure Premium Rates approved by the Insurance Commissioner reflect only loss costs, including loss adjustment expenses; they do not include any provision for general expenses, commissions, other acquisition expenses, premium taxes, or profits. The Insurance Commissioner's adopted Pure Premium Rates are advisory only. The law does not require insurers to adopt these rates.

The Pure Premium Rates proposed by the WCIRB in its March 30, 2007 filing are 11.3% lower (-11.3%) than the Pure Premium Rates that were approved effective January 1, 2007. These proposed rates were based on the WCIRB's analysis of aggregate loss and premium experience valued by the WCIRB as of December 31, 2006.

For the reasons detailed below, the Department of Insurance proposes to adopt Pure Premium Rates that are 14.2% lower (-14.2%) than the current rates—those that have been in effect since January 1, 2007. The pure premium rates adopted herein are based on the hearing testimony and an examination of all materials in the record by the hearing panel, which included two of the Department's senior actuaries, Ronald Dahlquist and Eric Johnson, who both did the primary analysis and determination of the adjustment of the Pure Premium Rates contained in this Proposed Decision.

Effect of the Permanent Disability Rating Schedule

The WCIRB's current filing includes a revised assumption regarding the effect of the Permanent Disability Rating Schedule (PDRS), which became effective on January 1, 2005. In prior filings, the WCIRB had assumed that the new PDRS reduced permanent disability losses by 38%. In the present filing, the WCIRB has reduced its assumed effect of the PDRS further to 50%.

Our evaluation of the effect of the new PDRS is divided into two tasks. The first task is to evaluate the effect of the new PDRS on the permanent disability benefits to be paid out on injuries that are still ratable under the new PDRS. The second task is to evaluate the permanent disability benefits that are removed from the system because the new PDRS eliminates permanent disability benefits entirely for some claims that were formerly eligible under the previous PDRS.

The first task has been undertaken by a series of studies performed by Mr. Frank Neuhauser, Project Director for the University of California, Berkeley's DATA/Survey Research Center, done at the request of the Commission on Health and Safety and

Workers' Compensation (CHSWC). These studies compare actual ratings given under the new PDRS to ratings on similar claims given under the prior schedule. The WCIRB's filing includes Mr. Neuhauser's latest study as Appendix C.

Mr. Neuhauser's latest study reviewed 30,537 claims that received ratings under the new PDRS. The average change in permanent disability benefit dollars from the prior permanent disability schedule is a decrease of -52.9% for the summary ratings and a decrease of -51.0% for the consults category. The weighted average effect, based on the numbers of ratings performed in each category, is an overall decrease of -51.6% in permanent disability benefit dollars. This current study utilizes twice as many ratings as the previous study, and its conclusions are quite similar. In fact, all of the studies of Mr. Neuhauser have been consistent since he first began studying this phenomenon.

At this time, there is no reason not to rely on the results of Mr. Neuhauser's latest study as the best estimate we have of the effect of the new PDRS on injuries that are still ratable for permanent disability.

The second task we undertook was to better estimate the percentage of claims that were ratable for permanent disability under the former permanent disability schedule but are no longer ratable under the new PDRS. We previously attempted to deal with this in prior Proposed Decisions as best as possible. Mr. Neuhauser was careful to point out that he did not attempt to address this issue in his studies, but the data in his studies was useful for evaluating this issue.

The assumption used in our last Proposed Decision was that 7% of all permanent disability claims would be ineligible for permanent disability benefits under the new PDRS. This assumption had been in common usage but was not backed by empirical data. Nevertheless, if this assumption were to be applied in combination with the latest Neuhauser study's result that the PDRS has reduced benefit dollars by 51.6% on claims that are still ratable under the new schedule, the overall effect of the PDRS would be estimated as -55.0%.

At the Hearing we requested that the WCIRB provide the latest available policy year data by type of injury from the Unit Statistical Plan. This data was provided in Exhibit 3 of the WCIRB's letter dated May 10, 2007 and consists of the percentage distribution of claims by type of injury by policy year starting with policy year 1995 and ending with policy year 2005. All data is as of the first Unit Statistical Plan report.

The data indicates that permanent disability claims reached a high of 15.7% of all claims in policy year 2002. Permanent disability claims reached a high of 45.2% of indemnity claims in policy year 2001. Preliminary information on policy year 2005 indicates that permanent disability claims have fallen to 9.9% of all claims and 34.5% of indemnity claims. Both of these percentages represent declines in permanent disability claims of more than 20% from their peaks.

Based on the evidence above, it is reasonable to estimate that 20% of permanent disability claims have been eliminated from permanent disability by the new PDRS. Combining this assumption with the latest Neuhauser study's conclusion that the new PDRS has reduced permanent disability benefits by 51.6% on average on claims that are still ratable under the new schedule, we estimate the overall effect of the January 1, 2005 PDRS as -61.25%. We further estimate that our conclusion regarding the effect of the new PDRS results in a projected on-level indemnity loss ratio of .252, instead of the ratio of .271 contained in the WCIRB filing.

Selection of Loss Adjustment Expense

In our proposed decision for the January 1, 2007, Pure Premium Rates, we rejected the WCIRB's selection for the ratio of allocated loss adjustment expense to loss based upon the average of the latest three years' data. We selected the average of the latest two years, and for the reasons set forth in our prior Proposed Decisions, we make the same selection again.

Overall Effect and Conclusion Regarding the Pure Premium Rates

The combined effect of our analysis above combined with the evaluation made by the WCIRB of the indicated Pure Premium Rate level results in the change from the WCIRB indicated decrease of -11.3% to a decrease of -14.2%.

ADEQUACY OF THE RECOMMENDED PURE PREMIUM RATES

There have been major changes in the adequacy of insurer rates over the last twelve years. Insurer pricing strategies have contributed to both the inadequate rates charged in the late 1990s and the excessive rates charged in recent years. Excessive competition in the late 1990s contributed to the rash of insolvencies that occurred. Insurers' conservatism in reflecting the impacts of the reforms in their pricing has led to the historically low loss ratios and very substantial profitability experienced in the last three years.

Based upon these major rate swings, we believe that it is a worthwhile endeavor to determine to what extent there have been inaccuracies in the recommended Pure Premium Rates and how to improve their development. The purpose of this analysis is to evaluate the effectiveness of the recommendations given to us by the WCIRB and make recommendations as to how to improve the information and data that the Insurance Commissioner and the Department must rely upon for issuing adjustments to the Pure Premium Rates.

Historical Insurer Rate Levels

At the public hearing on May 3, 2007, we asked the WCIRB to provide a calculation showing the estimated ultimate industry loss ratios by accident year since 1995 at the pure premium rate levels that were in effect historically. This was provided to us in the

WCIRB letter dated May 10, 2007 and is found in Exhibit 2, which shows that insurer pricing has varied substantially over the twelve-year time span of the open rating era.

As shown in column 10 of Exhibit 2, the industry was charging less than the approved pure premium rates, on average, for the five years beginning in 1996 and ending in 2000. The low point was in 1999, when insurer rates were 95.2% of the approved pure premium rates.

Since 2000, the industry's average price level relative to the pure premium rate level has increased dramatically. By 2003, the average insurer rate level was 129.5% of the pure premium rate level. In 2004, insurers charged 142.6% of the pure premium rate level, and in 2005, the average price level rose to 149.2% of the pure premium rate level. This represents a load of nearly 50% over the pure premium rates for company underwriting expenses and profit. Considering the investment income to be earned on the premium funds before all expenses and benefits are paid, this represents an expectation of extraordinary profits. The 2006 level has declined only slightly, to 147.2%.

Historical Pure Premium Rate Adequacy

Exhibit 2 also shows in column 12 the historical loss and loss adjustment expense (LAE) ratios that would have occurred if insurers had charged exactly the approved pure premium rates throughout the entire 12-year period. Since the pure premium rates are supposed to provide for losses and LAE only, a loss and LAE ratio of 1.000 indicates that the pure premium rates were exactly accurate. This column shows that, with the benefit of hindsight, the approved pure premium rates have been substantially inaccurate over the 12-year time span. For the first eight years, from 1995 through 2002, the pure premium rates were inadequate. For the last four years, they have been redundant. The degree of the inaccuracy has been substantial.

With the benefit of hindsight, the pure premium rates in 1995 should have been 30% higher than they were. For the three years 1998-2000, adequate pure premium rates would have been more than 50% higher than the approved pure premium rates. The peak of inadequacy was reached in 1999, when it appears that pure premium rates should have been 60% higher than they were. After 1999 the deficiency began to narrow. By 2002, the adequate pure premium level was 19% higher than the approved level.

The picture of pure premium accuracy is completely opposite after the reforms enacted in 2003 with AB 227 and SB 228 and in 2004 with SB 899. In 2003, the adequate pure premium level was 92% of the approved pure premium level, indicating that the pure premiums were redundant by a modest 8%. With the impact of the more comprehensive reforms, however, pure premium rate redundancy rapidly became substantial. In 2004, the adequate pure premium rate level was 70% of the approved pure premium rate level. In 2005, it was 50%, meaning that the pure premium rates should have been only half of what they were. In 2006, the situation has improved some; pure premium rates should have been two-thirds of the approved pure premium rate level.

Implications and Observations

Certainly, accurate prediction of Pure Premium Rates has been challenging and difficult throughout the entire 12-year period. Fundamentals of the workers compensation claims environment have changed in ways that have been difficult to quickly identify and quantify, since the changes do not immediately show in the data. For example, the *Minniear* decision in 1996, which gave the primary treating physician's opinion the presumption of correctness for all issues of medical treatment, is thought to have opened the door to a trend of ever-increasing utilization of medical services. Also, the extent to which the January 1, 2005 permanent disability rating schedule has reduced permanent partial indemnity benefits has been a major surprise.

It is our opinion that a critical review of the WCIRB ratemaking process is in order. We direct the WCIRB to begin such a review, and to provide the Department of Insurance with periodic updates on their progress and their findings. This study should address both the reasons why pure premium rates were so inadequate from 1995 through 2002 and why they were redundant from 2004 to the present. It should also produce recommendations for changes to the WCIRB pure premium ratemaking process that would greatly reduce the likelihood of such recurrences in the future. These changes should serve to increase the responsiveness of the pure premium ratemaking methodology to changing conditions. While we do not think it is appropriate for us to specify the methods to be used in the study, we present the following observations which we believe are pertinent to the overall effort.

Pre-Reform Period

The ultimate losses used to determine the indicated pure premiums have always been calculated using the paid loss development method. The track record of the paid loss development method leaves much to be desired. Paid medical age-to-age factors increased steadily from as early as 1995 until the major reforms were implemented in 2004. Paid indemnity age-to-age factors began to increase in 2000 and continued to increase through 2004 for the earlier stages. For medical, and to some degree for indemnity, the most recent paid age-to-age factors continue to increase for the later stages of development. These long-term trends in the age-to-age factors have resulted in serious underestimation of the ultimate losses and thus the filed and approved pure premium rate levels. They are also clear indications that something was wrong with the basic paid loss development method.

The WCIRB's response to this phenomenon was to trend the medical age-to-age factors, so that the factors applied in the development analysis were larger than any of the factors observed historically. This approach was considerably more aggressive than what appeared to be the standard actuarial practice among appointed actuaries analyzing workers compensation loss reserve requirements for Annual Statement purposes; however, it clearly was not aggressive enough, based on subsequent development.

One obvious problem with the paid loss development method is that a long-term slowdown in claims closure rates is readily apparent, and has been for some time. This is a clear indication that a principal assumption of the paid loss development method has been violated. The actuarial literature on reserving methodology includes a number of statements that if the claims settlement rates are slowing down, the paid loss development method can be expected to underestimate ultimate losses. The Berquist-Sherman paper provides a method to adjust the historical paid losses to a common closure rate basis. This adjustment method is well-known to casualty actuaries practicing in the loss reserving area, since it is required reading for the CAS professional qualifying examination on loss reserving. There are complications in applying this adjustment to workers' compensation payment data due to the prevalence of partial payments in the line, and it is not clear that it would have provided a complete solution to the pre-reform estimation problems. However, the Berquist-Sherman adjustment is a well-known solution to a problem that has not been addressed in the WCIRB's ratemaking methodology, and its possible application should be seriously evaluated.

A more basic approach to the problem is to apply other actuarial loss reserve estimation methods that do not suffer from the distortions that have been seen in the paid loss development method. This is easier said than done, as all available methods are subject to possible distortions of some sort, and the recent historical period has been full of changes to the claims environment. The WCIRB has applied other methods in past filings, but only the paid loss development method has been used to determine the indicated pure premium rate level. The possible use of alternative methods should be revisited.

We also think that the experience of the pre-reform era indicates a need for better information regarding current conditions in the California workers compensation claims environment, so that "turning points" in loss experience and trends can hopefully be identified earlier than they have been in the past. Once reform legislation was passed, the WCIRB assembled a Special Committee constituted primarily of claims experts to assist in the evaluation of the effect of the legislative changes on claims costs. The WCIRB has continued to utilize external resources to track the emerging evidence of the effects of the reforms. We think there would be value in extending the Special Committee concept to include a standing committee of claims specialists and legal experts in workers' compensation that would hold regular meetings in order to provide the Bureau with better and timely information on emerging trends and other changes in the California workers compensation claims environment. We recommend that the WCIRB implement this approach.

Post-Reform Period

The WCIRB has put considerable effort into the evaluation of the various reforms, both immediately after their passage and subsequently, as actual experience in the post-reform environment has begun to emerge. Since the reforms have been comprehensive and far-reaching, significant impacts and unintended consequences could be expected. It is appropriate to recognize that considerable uncertainty exists in the immediate post-reform

environment. However, we believe that the WCIRB has approached the estimation of the cost impact of some of the major reform elements with excessive caution. The two prime examples we will discuss are the implementation of the ACOEM guidelines in the AB227/SB228 legislative package and the January 1, 2005 Permanent Disability Rating Schedule.

Savings from Medical Utilization Reforms

For its January 1, 2004, filing, the WCIRB was unable to decide on a single estimate of the impact of medical utilization guidelines would have on the overall pure premium level. The WCIRB filed what it said was a range of savings effects from 0%, or no effect, to -2.5% of total indemnity and medical losses.

It is important to understand what the WCIRB meant by savings. The WCIRB on-level medical pure premium ratios were increasing by about 5% a year. "On-level" means after adjusting for known quantifiable effects, the primary ones being fee schedule changes and wage inflation. Any observable trend after making all these adjustments can be called the residual trend or inflation. The WCIRB started with the base assumption that the pure premium ratios, in the absence of reforms, would continue to deteriorate at this 5% rate. It counted any reduction in this 5% rate of deterioration as savings. The high end of their savings effect, -2.5%, was based on the assumption that the residual medical inflation would continue, but at only half the rate. In other words, the most favorable or optimistic interpretation that the WCIRB gave to the medical utilization reforms, initially, is that the dire crisis would continue to worsen, but at a somewhat lower rate.

Frank Neuhauser of the University of California had prepared a study for CHSWC that estimated the savings. Mr. Neuhauser's definition of savings was fundamentally different from the WCIRB's and did not assume that, absent the reforms, the situation would continue to worsen or count as savings any reduction in the worsening. Rather, he defined savings more narrowly, as an actual reduction from then current situation. Mr. Neuhauser estimated the savings at 22.5% of medical, or 13.5% of total losses. While Mr. Neuhauser's study relied on a number of assumptions, he laid them out clearly in a thoughtful seven-step calculation.

In its filing, the WCIRB did not discuss Mr. Neuhauser's study, did not analyze his assumptions in any systematic way, and did not do any calculations using his formula or propose any modifications to his formula. Had the WCIRB been correct in 2003 and 2004, the subsequent on-level medical pure premium ratios would be flat. Instead, when we look at the WCIRB's current filing, the ratios decline from a high of .681 for accident year 2002 down to .455 for accident year 2006. This is a drop of 33%. This 33% drop is from the then current situation in 2002, not from some projected further deterioration of the situation in 2002 to 2006.

Each year the WCIRB produces a Legislative Cost Monitoring Report that provides a scorecard on the effectiveness of the legislative reforms in reducing claims costs. It also

provides an additional scorecard on how well the WCIRB has done in projecting the savings from the reforms. The latest report was issued in September 2006.

For some of the specific provisions of the reforms, the WCIRB did quite well. For example, their original estimate of the savings from the new outpatient fee schedule was 41% and their current estimate, based on actual experience, is 39%. On the other hand, for the pharmaceutical fee schedule, their original estimate of the savings was 37% and their current estimate is 13%. The WCIRB did not anticipate the effect of the failure of the fee schedule to cover repackaged pharmaceuticals.

For the medical utilization provisions (other than the caps on chiropractic and physical therapy visits), the WCIRB reports that their original estimate of the savings was 25%. This estimate is from the 2004 filing, rather than the 2003 filing. In keeping with the approach noted above, this 25% represents the difference between projecting the medical pure premium ratios forward at a 5% increase per year compared to projecting the ratio forward with no increase. How good was this projection according to the WCIRB? Their report includes a statement that says "Growth Trend Eliminated; Approx 5% Reduction in Visits". There is no mention of the 34% drop in the medical pure premium ratio from 2002 to 2005 that is shown in the WCIRB's January 1, 2007 pure premium rate filing made in the same month.

2005 Permanent Disability Rating Schedule

Senate Bill 899, enacted in April 2004, directed the Administrative Director of the Division of Workers Compensation to develop a new Permanent Disability Rating Schedule incorporating the American Medical Association's Guidelines for determining the extent of disability. This revised rating schedule was to be effective no later than January 1, 2005. The Administrative Director met this deadline, completing the new PDRS in December 2004, and the schedule became effective on January 1, 2005.

- **1-1-2005 Filing**

The WCIRB attributed no effect to the new PDRS in its January 1, 2005 filing, because the new schedule had not been completed as of either the filing date or the close of the filing hearing record. While there was possibly no other way the WCIRB could have treated the estimation problem, this had the unfortunate effect of delaying recognition in the pure premium rates of a change to the benefit structure that has subsequently proven to significantly reduce costs.

The Bureau chose an overly cautious approach, however, when it also chose to not attribute any pure premium rate level effect to either of two SB899 provisions that modified the existing permanent disability benefits but would not go into effect until the new PDRS went into effect. The first of these provisions involved changes to the existing schedule of the number of weeks of permanent disability to be paid, depending on the injured worker's disability rating. The second provision involved the institution of a two-tiered permanent disability structure, with lower benefits to be paid if the employer

offered a return to work to the injured worker, and higher benefits if a return to work was not offered. These changes were easily quantifiable if the assumption of no change to the PDRS was made, and the likelihood that a new PDRS would not be adopted could best be described as remote. The WCIRB's choice to attribute no effect to these provisions of SB899 thus had the effect of not reducing the filed pure premium rates for legislative changes that were for all intents and purposes certain to reduce permanent disability benefits.

- 7-1-2005 Filing

Once the new 2005 Permanent Disability Rating Schedule was adopted, the WCIRB commissioned three studies of its effects. Only the first two were available in time to be considered for the July 1, 2005 pure premium rate filing.

The first study involved re-rating a sample of 250 recently decided cases using the requirements of the new schedule. The overall result of Dr. Brigham's re-rating was an 80% reduction in permanent disability benefits, but in his oral testimony, he provided an educated guess that the actual reduction in ratings and costs for ratable injuries under the new schedule would be likely to be in the range of 20% to 30% due to assumed inconsistencies in application of the new schedule by the DEU.

The second study involved comparing maximum whole body impairment disability ratings by impairment category between the old and new permanent disability schedules. This study was performed by Mr. Frank Neuhauser. He determined that the impact of the new schedule would be a significant overall decrease if it were not for the adjustments for loss of future earning capacity. After considering this, he concluded that the overall result would be an increase of about 1% on permanent disability costs. An adjustment that limited the maximum ratings for spine impairments resulted in an alternate estimate that costs would decrease by about 7%. The Department viewed the key assumption of this study as being unrealistic, and so viewed the results of the study as insufficiently supported.

Based on its view of the results of these studies, the WCIRB's estimated that the effect of the new PDRS was a 12% decrease to permanent disability benefits. The Department believed at the time that this was an overly conservative estimate. We estimated the decrease at 30% without considering a negative utilization effect, and at 38% with the utilization effect.

- 1-1-2006, 7-1-2006, and 1-1-2007 Filings

The WCIRB assumed that the effect of the January 1, 2005 Permanent Disability Rating Schedule was a 38% decrease in all three of these filings. As mentioned previously, Mr. Neuhauser has performed a series of studies comparing actual ratings given under the new PDRS to ratings on similar claims given under the prior schedule. The first of these studies was available in time to amend the January 1, 2006 filing. Based on a volume of 1,501 claims, the average reduction in permanent disability ratings presented in the report

was approximately 38.5%. At the September 1, 2005 meeting of the WCIRB Special Committee, the corresponding average measured reduction in permanent disability benefits was stated to be approximately -48%. It is important to keep in mind that none of Mr. Neuhauser's studies attempted to measure the impact of the claims eliminated from eligibility for permanent disability benefits, as was stated earlier in this document. The WCIRB adopted its 38% decrease assumption after reviewing the initial study.

A second study, dated February 8, 2006, was based on 7,134 claims, and showed an average reduction of approximately 54%. This study was used by the WCIRB to justify maintaining its assumption of a 38% decrease in permanent disability benefits in its July 1, 2006 filing. A third study, dated July 5, 2006, was based on 10,466 claims and measured an average reduction in PD benefits of approximately 52%. In response, the WCIRB yet again maintained its -38% assumption in the January 1, 2007 filing.

Although successive studies, performed on increasing volumes of claims, have shown consistently larger impacts on actual ratings, the WCIRB has maintained its 38% decrease assumption until the current filing.

Taken as a whole, it is our opinion that this history demonstrates that the WCIRB has been slow to recognize and react to the growing body of evidence that the January 2005 PDRS has substantially reduced permanent disability benefits. A more timely response to this evidence would have resulted in more accurate pure premium rates, in our estimation.

Other Comments

It is our opinion that the WCIRB's standard Exhibits 6 and 7 in its filing of March 30, 2007 are in need of a significant overhaul. These exhibits are intended to show past losses and premiums adjusted to the levels of pure premiums in effect as of the filing date, and the level of claims costs that is expected for the prospective period the proposed pure premiums will be in effect. Ideally, these exhibits would display on-level accident year pure premium ratios that would display no clear trend, and only random variations. In this ideal situation, it would be possible to determine an appropriate indicated pure premium ratio by giving weight to the on-level pure premium ratios of a number of historical accident years.

It is clear from even a cursory examination of the graphs on Exhibit 7, however, that prior accident years' pure premium ratios are not really "on level". It follows that key factors must be missing from the WCIRB's on-level adjustments. It is our opinion, for example, that the impact of the medical utilization reforms is inadequately represented in the existing on-level adjustments. We also believe that there is a need to address loss trend more thoroughly. It is true that the WCIRB in past years has used these on-level exhibits to identify the existence and magnitude of residual trends. However, if a large residual trend is showing, it would seem to be a clear indication that something is systematically missing from the trend evaluation. We believe that the WCIRB should study ways to

include more relevant information in its on-level adjustments so that the historical distortions that are so evident currently will be reduced or even eliminated in the future.

Profitability

Every quarter the WCIRB submits solvency monitoring data to the CDI. Among other things, it reports the industry-wide insurer rate levels as a ratio of the approved advisory pure premium level. Since the beginning of open competition in 1995, this ratio has varied from .952 in 1999 up to 1.508 for written premium in the fourth quarter of 2006. These numbers are industry-wide ratios and individual companies will have ratios that are higher or lower. In 1999 some companies may have had ratios as low as .800.

Using standard actuarial ratemaking formulas (such as the proposition 103 rate formula) and various assumptions on expenses, reserves, yield, taxes, leverage and rate of return, we have calculated that a workers compensation insurer can be reasonably profitable at a premium-to-advisory-pure-premium ratio of 1.05.¹ To put it another way, the additional 5% above the amount necessary to pay for claims and adjustment expenses, when combined with investment income, should provide enough revenue to pay for a company's acquisition and general expenses and taxes and still leave enough left over for a healthy profit.

The actual industry-wide ratio of 1.508 exceeds our calculated target of 1.05 by more than 40%. Using the same ratemaking formula and assumption, a 1.508 ratio produces an after-tax return on statutory surplus of 25.8%. Clearly this represents an opportunity for premium reductions beyond the decrease in the advisory pure premium we propose. It also represents a significant profit opportunity for companies who have been standing on the sidelines waiting to see how the reforms in California would play out. The declining paid loss development factors and pure premium ratios show that the reforms have played out quite well, in terms of lower claims, and much better than the WCIRB forecasted.

OTHER MATTERS

Amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995

The WCIRB has proposed amendments to the California Uniform Statistical Reporting Plan—1995 to be effective on July 1, 2007 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after July 1, 2007. Those amendments include the effective date of the amendments; changes for clarity, consistency, and/or editorial purposes; amendments to address the audit requirements related to Assembly Bill No. 881 (2006), which requires each policy written for a C-39 licensed contractor to

¹ These assumptions are: 16.7% acquisition, general expenses and premium tax, 3.09 ratio of loss reserves to incurred losses, .22 ratio of unearned premium reserve to earned premium, 6.72% yield on invested assets, including unrealized capital gains, 32.88% federal income tax on investment income and 35% federal income tax on underwriting profit, premium to surplus ratio of 1-to-1 and 10.88% after-tax rate of return on statutory surplus.

be audited; amendments to clarify the applicability of the change in the physical audit threshold from \$16,00 to \$10,000 that was adopted effective January 1, 2007; and amendments to clarify the timing of the Unit Statistical Report filing requirements. All these amendments have been reviewed and, having received no objections regarding them, are approved as being reasonable and consistent with the purpose of this Plan.

Amendments to the California Workers' Compensation Experience Rating Plan—1995

The WCIRB has proposed amendments to the California Experience Rating Plan—1995 to be effective on July 1, 2007 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after July 1, 2007. The first amendment proposed to Section I changes the effective date of the amendments to July 1, 2007, which is reasonable and consistent with the purpose of this Plan and is approved.

The second amendment proposed to Section III adjusts the eligibility requirement for experience rating from \$16,000 to \$14,192 to reflect the amendments in pure premium rates proposed in this filing based upon the decrease of -11.3% of the Pure Premium Rates. This amendment is also reasonable; however, we have concluded the decrease of the Pure Premium Rates should be -14.2%. Therefore, the WCIRB is directed to adjust the eligibility threshold to reflect the Insurance Commissioner's adopted Pure Premium Rates in order to maintain approximately the same volume of experience rated employers.

The third and final amendment proposed is to modify the Expected Loss Rates (ELR) shown in Table II of the Experience Rating Plan to reflect the most current experience available. This proposal has received opposition from two witnesses, who are both insurance brokers. The evidence presented in opposition to this amendment consisted of two written submissions and an oral presentation at the hearing of May 3, 2007.

The WCIRB's proposal to amend the ELR is expressed in Appendix A of Part B, Section B of its filing and includes an explanation of ELR. Specifically, ELR is an estimate of the losses that can be expected from all employers of similar size within the same classification. A classification is the list of occupations, employments, industries, and businesses contained in the alphabetical listing of standard classifications located in Part 3, Section VII of the Uniform Statistical Reporting Plan—1995. The ELR has been amended a number of times in previous filings of the WCIRB, and those amendments have been approved after being reviewed and no opposition being received.

The main contention of the opposition to the current amendment of ELR is that adjustment of ELR will result in a decrease of favorable experience modifications and result in increased premiums to employers. This contention is not quite accurate. As a result of the decrease in claims and claims costs to the system, the overall experience in the system has been towards decreasing claims and claims costs. This applies equally to both employers with very good claims experience and very poor claims experience. This has resulted in a drop in the expected claims costs in the system for all employers.

As noted by the WCIRB in its supplemental filing of May 10, 2007, the adjustment recommended to the ELR will more closely approximate the estimated cost of losses and loss adjustment expenses to be incurred on those policies. This in turn, as noted by the WCIRB, will generate more accurate experience modifications, which is a primary goal of the experience system. Without these changes to the ELR, the WCIRB notes, and there is no reason to not accept this as valid based upon the evidence presented, that the proposed Pure Premium Rates for July 1, 2007 would be insufficient to fund the cost of losses and loss adjustment expenses for policies incepting on or after July 1, 2007 and create an imbalance between experience rated and non-experienced rated employers.

The opponents to the change of the ELR state the effect of amending the ELR will off-set the proposed decrease in the Pure Premium Rates and result in increased premiums. This is not entirely correct. An experience modification that is in favor of an employer only reduces premium by a percentage portion of the overall premium. In addition, it is difficult to predict what an insurer will do in pricing its workers' compensation insurance for a particular employer. It would be helpful to have specific examples of increases that have occurred or may occur as a result of these requested changes to the ELR in the future to be able to fully evaluate this issue, but that was not presented.

Therefore, based upon the evidence presented by the WCIRB, the need to make adjustments in-line with the current Experience Rating Plan, and the need to adequately reflect the changes in the workers' compensation system, the WCIRB is directed to adjust the ELR pursuant to its filing.

In reviewing this change to the ELR and the opposition that was presented, it is obvious that the system developed in the Experience Rating Plan is quite complex and not easily understood. It also is noted that the WCIRB had recommended a change in the Experience Rating Formula in the January 1, 2006 rate filing and was directed to evaluate the effects of the reforms and developing experience before such change would be approved. We have not yet heard back from the WCIRB on the status of that request.

Therefore, the WCIRB is directed to re-evaluate the Experience Rating System in light of the changes to the workers' compensation system and to explain how the current system complies with Insurance Code Section 11736, particularly with regard to providing adequate incentives for loss prevention and sufficient premium differentials so as to encourage safety. The WCIRB shall report back regarding the issues surrounding the Experience Rating Plan noted in this Proposed Decision in its next rate filing and suggest options regarding possible modifications and changes to improve this System.

Timing of Proposed Decision and Waiver of Filing and Time Requirements

Given that workers' compensation rate filings are not effective until 30 days after filing, a waiver of the time limit pursuant to Insurance Code section 11735 shall be granted for amended rating plans filed by insurers that contain a change in multiplier to reflect the approved pure premium rate decrease adopted herein of -14.2% or less for all new and

renewal policies with anniversary rating dates on or after July 1, 2007. Such rates shall be effective upon filing with the commissioner, subject to further appropriate review by the Commissioner according to the Insurance Code. In addition, insurers making such rate filings shall not be required to include independent actuarial support.

PROPOSED ORDER

WHEREFORE, IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner of the State of California by California Insurance Code sections 11734, 11750, 11750.3, 11751.5, and 11751.8 that the advisory workers' compensation Pure Premium Rates and Sections 2318.6 and 2353.1 of Title 10 of the California Code of Regulations are hereby amended and modified in the respects specified herein;

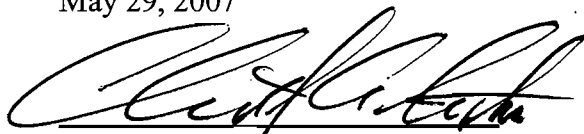
IT IS FURTHER ORDERED that the experience rating threshold be calculated to reflect the Pure Premium Rates decrease adopted herein;

IT IS FURTHER ORDERED that these regulations shall be effective July 1, 2007 for all new and renewal policies with anniversary rating dates on or after that date; and

IT IS FURTHER ORDERED, pursuant to Insurance Code section 11735, that amended rating plans filed by insurers as specified herein shall be effective upon filing with the commissioner and insurers making such filings shall not be required to include independent actuarial support.

I HEREBY CERTIFY that the foregoing constitutes my Proposed Decision and Proposed Order in the above entitled matter as a result of the hearing held before me as a Senior Staff Counsel of the Department of Insurance on May 3, 2007, and I hereby recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

May 29, 2007

A handwritten signature in black ink, appearing to read 'Christopher A. Citko', written over a horizontal line.

Christopher A. Citko
Senior Staff Counsel